

# **REPORT OF THE AUDIT OF THE KENTUCKY LOTTERY CORPORATION**

**For The Fiscal Year Ended  
June 30, 2002 and 2001**



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EDWARD B. HATCHETT, JR.  
AUDITOR OF PUBLIC ACCOUNTS

To the People of Kentucky  
Honorable Paul E. Patton, Governor  
Honorable David L. Williams, President, Kentucky Senate  
Honorable Jody Richards, Speaker, Kentucky House of Representatives  
Board of Directors, Kentucky Lottery Corporation

As Auditor of Public Accounts, I am pleased to transmit herewith the Financial Statements and Independent Auditor's Report of the Kentucky Lottery Corporation for the years ended June 30, 2002 and 2001, pursuant to KRS 154A.130(5).

The information presents fairly and fully discloses the financial position and results of financial operations of the Kentucky Lottery Corporation for the reporting period as measured by the financial activity.

Respectfully submitted,

A handwritten signature in black ink, appearing to read "Ed Hatchett".

Edward B. Hatchett, Jr.  
Auditor of Public Accounts





KENTUCKY LOTTERY CORPORATION  
FINANCIAL STATEMENTS AND  
INDEPENDENT AUDITOR'S REPORT  
JUNE 30, 2002 AND 2001



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## INDEPENDENT AUDITOR'S REPORT

To the Auditor of Public Accounts, Commonwealth of Kentucky and  
the Board of Directors, Kentucky Lottery Corporation

We have audited the accompanying financial statements of the Kentucky Lottery Corporation (the Corporation) as of June 30, 2002 and 2001 as listed in the table of contents. These financial statements are the responsibility of the Corporation's management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with auditing standards generally accepted in the United States of America and *Government Auditing Standards* issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

As discussed in Note 2, the financial statements present only Kentucky Lottery Corporation, and are not intended to present fairly the financial position of the Commonwealth of Kentucky, or the results of its operations and cash flows of its proprietary fund types in conformity with generally accepted accounting principles.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of the Kentucky Lottery Corporation as of June 30, 2002 and 2001, and the results of its operations and its cash flows in conformity with accounting principles generally accepted in the United States of America.

The Management's Discussion and Analysis on pages 2 through 5 are not a required part of the basic financial statements but is supplementary information required by the Governmental Accounting Standards Board. We have applied certain limited procedures, which consisted principally of inquiries of management regarding the methods of measurement and presentation of the required supplementary information. However, we did not audit the information and express no opinion on it.

As described in Note 2 to the financial statements, the Corporation adopted the provisions of Governmental Accounting Standards Board Statement No. 34, *Basic Financial Statements—and Management's Discussion and Analysis—for State and Local Governments*. This results in a change to the format and content of the basic financial statements.

In accordance with *Government Auditing Standards*, we have also issued our report dated July 26, 2002 on our consideration of the Corporation's internal control over financial reporting and our tests of its compliance with certain provisions of laws, regulations, contracts and grants. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* and should be read in conjunction with this report in considering the results of our audit.

*Potter & Company, LLP*

POTTER & COMPANY, LLP  
July 26, 2002

## ***Management's Discussion and Analysis***

Our discussion of the Kentucky Lottery Corporation's (the KLC) financial performance provides an overview of the KLC's financial activities for the fiscal year ended June 30, 2002. Please read it in conjunction with the financial statements, which begin on page 8.

### Financial Highlights

- Operating revenues for the year were a record \$638.7 million, an increase of \$47.9 million, or 8.1%.
- Gross profits for the year increased by \$9.6 million, or 4.8%.
- Operating expenses decreased by 1% to \$41.2 million.
- Income before transfers out increased \$15 million, or 9.4%.
- Transfers to the General Fund/Education programs and the Affordable Housing Trust Fund increased \$13.5 million, or 8.5%

### Using This Annual Report

The KLC is accounted for as an enterprise fund, reporting on all of the activity's assets and liabilities using the accrual basis of accounting much like a private business activity.

As such, this annual report consists of a series of financial statements, along with explanatory notes to the financial statements and supplemental schedules. The Statements of Net Assets on page 8 and the Statements of Revenues, Expenses and Changes in Net Assets on pages 9-10, report the KLC's net assets and changes in them.

To assess the KLC's financial position and financial health, the reader of these statements should pay particular attention to changes in the components of assets and liabilities as set forth on the Statements of Net Assets, and in changes in operating revenues and expenses as set forth in the Statement of Revenues, Expenses and Changes in Net Assets.

### Total Assets

Total assets consist primarily of cash and cash equivalents, investments, accounts receivable and capital assets. As shown in Table 1 below, overall the KLC's total assets decreased \$10.6 million during the year from \$322.8 million to \$312.2 million. Cash, cash equivalents and investments decreased \$9.2 million from \$285.8 million to \$276.6 million due primarily to installment payments on prize liabilities. Investments consist of U.S. Treasury zero-coupon bonds and other U.S. Government agency securities carried at fair value. Accounts receivable represents revenue to be collected from the sales of on-line game tickets and the sale of instant scratch game tickets to retailers. Capital assets consist of buildings, game equipment, data processing equipment, etc. utilized by the KLC in the sale of on-line and instant game tickets.

### Capital Assets

The KLC's investment in capital assets amounts to \$13.2 million net of accumulated depreciation. This investment in capital assets includes buildings, game equipment, data processing equipment, automobiles, furniture and fixtures. The total increase in the KLC's investment in capital assets for the current fiscal year was \$2.0 million or 18%. The major capital asset event during the current fiscal year was the acquisition and development of software related to enhancements in retailer accounts receivable data processing and the implementation of enhanced "e-business" systems and capabilities. Additional information on the KLC's capital assets can be found in note 6 to the financial statements.

**Management's Discussion and Analysis (Continued)**

Table 1  
Net Assets  
(in millions)

	<u>2002</u>	<u>2001</u>
Current and other assets	\$69.9	\$77.0
Investments	225.5	231.0
Capital assets, net	13.2	11.2
Deposits with MUSL	<u>3.6</u>	<u>3.6</u>
Total assets	<u>312.2</u>	<u>322.8</u>
Current liabilities	58.3	57.9
Long-term liabilities	<u>205.0</u>	<u>218.3</u>
Total liabilities	<u>263.3</u>	<u>276.2</u>
Net Assets		
Invested in capital assets	12.8	9.5
Restricted for unrealized gains on investments	22.5	14.9
Unrestricted	<u>13.6</u>	<u>22.2</u>
Total net assets	<u>\$48.9</u>	<u>\$46.6</u>

Liabilities

Table 2  
Liabilities  
(in millions)

	<u>Current</u>		<u>Long-term</u>	
	<u>2002</u>	<u>2001</u>	<u>2002</u>	<u>2001</u>
Prize liabilities	\$47.8	\$45.3	\$205.0	\$218.0
Due to other funds	3.7	5.1	-	-
Notes Payable	.3	1.4	-	.3
Accounts payable and other liabilities	<u>6.5</u>	<u>6.1</u>	<u>-</u>	<u>-</u>
Total liabilities	<u>\$58.3</u>	<u>\$57.9</u>	<u>\$205.0</u>	<u>\$218.3</u>

Total current liabilities increased by \$.4 million or .7% in 2002. The due to other funds account decreased by \$1.4 million. This is due to timing issue and represents funds transferred to the Affordable Housing Trust Fund after the fiscal year end.

Long-term liabilities consist principally of prize liability for prizes paid in installments over several years. Long-term prize liability decreased by \$13 million or 6% in 2002. This decrease is due to the fact that there was only one addition to the pool of installment prizes in 2002; most people who could have chosen to have their prize paid in installments chose single discounted cash payment instead.

## ***Management's Discussion and Analysis (Continued)***

### Net Assets and Changes in Net Assets

As shown in Table 1 above, the KLC's net assets increased slightly from a year ago, from \$46.6 million to \$48.9 million. This year's increase is mainly attributable to the increase in market value of investments the KLC holds to fund future payments due on annuitized lottery prizes. Accounting principles dictate the KLC record in the financial records the gain or loss related to the change in market value of these investments. Zero-coupon U.S. government bonds have been purchased for the payment of installment prize awards and are generally held to maturity. Therefore, the change in the market value of these investments is recorded as a restriction for unrealized gain on investments. The unrealized gain on investments is not available for transfer to the Commonwealth's general fund. The KLC's investment in capital assets, net of related debt, of \$12.8 million is also not available for transfer to the Commonwealth's general fund as these assets are utilized in the KLC's day-to-day operations. The remaining net assets of \$13.6 million are unrestricted and are available for transfer to the Commonwealth's general fund based on the KLC's cash flow and working capital requirements.

### Sales and Prize Expenses

#### Sales

**Table 3**  
**Lottery Sales**

	<u>Scratch-off</u>		<u>Pull-tab</u>		<u>Pick 3</u>		<u>Pick 4</u>	
	<u>2002</u>	<u>2001</u>	<u>2002</u>	<u>2001</u>	<u>2002</u>	<u>2001</u>	<u>2002</u>	<u>2001</u>
Sales	\$ 297.8	\$ 272.9	\$ 32.1	\$ 32.7	\$ 122.7	\$ 114.1	\$ 29.7	\$ 27.3
Gross Prizes	199.3	180.5	22.4	22.8	78.1	69.7	16.0	13.0
Less								
Unclaimed Prizes	(2.5)	(5.1)	(0.4)	(0.3)	(1.0)	(1.0)	(0.4)	(0.4)
Net Prizes	196.8	175.4	22.0	22.5	77.1	68.7	15.6	12.6
Gross Margin	<u>\$ 101.0</u>	<u>\$ 97.5</u>	<u>\$ 10.1</u>	<u>\$ 10.2</u>	<u>\$ 45.6</u>	<u>\$ 45.4</u>	<u>\$ 14.1</u>	<u>\$ 14.7</u>

  

	<u>Powerball</u>		<u>KY Cash Ball/Cash 5</u>		<u>Lotto South/Lotto KY</u>		<u>Total</u>	
	<u>2002</u>	<u>2001</u>	<u>2002</u>	<u>2001</u>	<u>2002</u>	<u>2001</u>	<u>2002</u>	<u>2001</u>
Sales	\$ 112.1	\$ 97.5	\$ 17.1	\$ 18.1	\$ 27.2	\$ 28.2	\$ 638.7	\$ 590.8
Gross Prizes	56.0	48.9	8.6	11.0	13.5	15.1	393.9	361.0
Less								
Unclaimed Prizes	(4.4)	(3.5)	(0.5)	(0.2)	(0.5)	(0.6)	(9.7)	(11.1)
Net Prizes	51.6	45.4	8.1	10.8	13.0	14.5	384.2	349.9
Gross Margin	<u>\$ 60.5</u>	<u>\$ 52.1</u>	<u>\$ 9.0</u>	<u>\$ 7.3</u>	<u>\$ 14.2</u>	<u>\$ 13.7</u>	<u>\$ 254.5</u>	<u>\$ 240.9</u>

Table 3 above compares sales, prizes, unclaimed prizes and gross margin (sales minus net prizes) for each lottery game category, FY 2002 versus FY 2001. The KLC produced record sales of \$638.7 million, a 8.1% increase over 2001 and record gross margin of \$254.5 million, a 5.6% increase over 2001. Additional total sales records achieved in 2002 included record first and third quarter sales and highest sales for one week of \$33.8 million.

### ***Management's Discussion and Analysis (Continued)***

Instant tickets are composed of two product categories, Scratch-Off tickets and Pull-Tab tickets. Scratch-off ticket sales, which accounted for 46.7% of all KLC sales, reached an all time high in 2002 at \$297.8 million, an increase of \$24.9 million or 9% over 2001. Sales growth within this product category was obtained at the \$2, \$5 and \$10 price points with increases of \$6.6 million or 5.5%, \$12.8 million or 46.3% and \$17.3 million or 134.1%, respectively. Sales declines were recognized at the \$1 and \$3 price points with decreases of \$8.6 million or 9.1% and \$3.2 million or 19.1%, respectively. The increase in market share for the KLC in the \$5 + segment of 8.9% is higher than the industry average increase of 5%, however the \$5 + segment market share industry average is 32% compared to 23.7% for the KLC. Despite a 4<sup>th</sup> quarter that was higher than the prior year, Pull-Tab sales experienced a slight decline to \$32.1 million in 2002.

The Daily games, Pick 3 and Pick 4 with drawings twice-a-day Monday through Saturday and once on Sunday, both achieved record sales of \$122.7 million and \$29.7 million, increases over 2001 of \$8.6 million or 7.5% and \$2.4 million or 8.8%, respectively. A spate of triple-digit combinations drawn mid-year helped spur Pick 3 sales and allowed it to finish the year with about 40% of the 2002 On-line share and generating the second-highest sales volume of any product (after Scratch-Off games).

The Kentucky Cash Ball product, which was introduced in March 2001, is a "mini-lotto" type game where players pick two sets of numbers for each draw from a matrix of "4 of 33" for the first set and "1 of 31" for the second set. Kentucky Cash Ball struggled early in the fiscal year, but received a boost in sales with the introduction of additional draw days which allow Cash Ball to be sold six days a week. Despite Cash Ball finishing the 4<sup>th</sup> quarter \$700,000 above quota, sales for 2002 were \$17.1 million, which was \$1 million or 5.5% less when compared to the combination of Cash 5 and Kentucky Cash Ball for 2001.

In September 2001, the KLC introduced Lotto South as a replacement game for Lotto Kentucky. The KLC participates in this game with the Georgia and Virginia. The increased population base allows for higher and faster growing jackpots than the KLC could generate on its own. Despite those attributes, combined Lotto South and Lotto Kentucky sales for 2002 were \$27.2 million about \$10 million less than quota and \$1 million or 3.5% less than 2001 Lotto Kentucky sales.

Powerball sales were fueled by a \$295 million jackpot in August 2001. On August 25, the KLC achieved a single day sales record with \$6.3 million in Powerball tickets sold. In 2002, Powerball sales totaled \$112.1 million, which was \$14.6 million or 15% increase over 2001.

#### **Prize Expense**

In general, prize expense by game should increase or decrease from year to year in proportion to the increase or decrease in sales for a particular game. However, except for the instant game product category, prize expense is also impacted by the luck of the draw. Prize expense for the instant game product category is controllable, to a large degree, by printing a predetermined number and value of winning tickets in the production of each instant game. Prize expense for all of the other lottery products is not predetermined. While each of these lottery products is designed to yield a certain ratio of prizes to sales over a large number of drawings, actual prize payout is determined by lottery players' luck in matching the particular set of numbers randomly selected in each drawing for each game. With that background, Table 3 shows the prize payout by lottery product for 2002 compared to 2001.

Gross prize expense in 2002 of \$393.9 million reflects a 9.1% increase from 2001's gross prize expense of \$361 million. This increase is slightly higher than the 8.1% increase in product sales experienced in 2001. Following is a discussion of notable variances in prize expense within certain product categories.

Within product lines, gross prize expense for the instant games increased 9% while sales from instant games increased 7.9%. This reflects the shift to the higher price points (more \$2, \$5 and \$10 games) as was discussed in the Scratch-off sales discussion above. As a rule, games with higher price points payout more in prizes than games that sell with a lower price.

### ***Management's Discussion and Analysis (Continued)***

Gross prize expense for Pick 3 increased by \$8.4 million or 12.1% in 2002, compared with a 7.5% increase in Pick 3 sales. Gross prize expense for Pick 4 increased by \$3 million or 23.1% compared with an 8.8% increase in Pick 4 sales. The difference for both games is due to players' overall greater luck in 2002 in matching the random numbers selected for each drawing. However, in Kentucky Cash Ball and Lotto South the opposite held true, gross prize expense decreased 21.8% and 10.6%, respectively, while sales for each game decreased 5.5% and 3.5%.

Net prize expense in 2002 was \$384.2 million or 60.2% of sales compared to \$349.2 million or 59.2% of sales in 2001. Unclaimed prizes in 2002 were \$9.7 million compared to \$11.1 million in 2001.

#### Other Expenses

Table 4  
Commissions, Operating and Other Expenses  
(in millions)

	<u>2002</u>	<u>2001</u>	<u>% Change</u>
Retailer commissions	\$39.8	\$36.3	9.6%
Ticket costs	\$7.0	\$6.6	6.1%
Operating expenses	\$41.2	\$41.6	(1.0%)
Amortization of prize discount	\$15.1	\$21.5	(30.0%)
Interest expense	\$ .1	\$ .2	(50.0%)

Retailer commissions and ticket costs in 2002 were 6.2% and 1.1% of sales, the same percentages as in 2001. Retailer commissions cover base selling and cashing commissions as well as a retailer incentive plan based on the sale of instant tickets. Ticket costs include the cost to produce and ship instant tickets. As Table 4 shows, operating expenses decreased 1% to \$41.2 million. Amortization of prize discount, which reflects the periodic write-off of the difference between the present value of installment prizes and the face value of said prizes, decreased by \$6.4 million or nearly 30% due to the fact that there are annually fewer installment prizes left to be paid as those that were awarded in earlier years have fewer payments remaining. More recent prize winners are electing to have their prizes paid in single cash payments instead of installment. Barring either a change in the federal income tax law that currently permits prize winners to elect cash option or a significant change in winners propensity to take cash, the number of prizes paid in installments will continue to decrease annually.

## ***Management's Discussion and Analysis (Continued)***

### Other Revenues

Table 5  
Other Revenues  
(in millions)

	<u>2002</u>	<u>2001</u>	<u>% Change</u>
Increase in fair value of investments	\$22.7	\$30.2	(24.8%)
Interest income	\$ .7	\$2.2	(68.2%)
Other miscellaneous revenue	\$ .2	\$ .3	(33.3%)

Increase in fair value of investments represents the change in market value of the KLC's investments held to fund prize installments. Since the KLC typically holds its investments to maturity to provide a secure funding vehicle for future prize payments, gain or loss in market value does not affect ongoing operations.

Interest income consists principally of interest on the KLC's cash balance, which is invested in short-term investments. The decline in interest income reflects the general decline in interest rates in 2002.

Miscellaneous revenues consists primarily of various fees assessed to retailers and income earned from a security lending program.

### Transfers Out

Transfers out represent a transfer of funds from the KLC to the Commonwealth's general fund and the Affordable Housing Trust Fund. The transfers out to the general fund, which are approved by the Board of Directors and remitted to the Commonwealth on a monthly basis, are appropriated by the General Assembly to provide funding for postsecondary education and literacy development. The transfers out to the Affordable Housing Trust Fund are used to address the critical housing needs of extremely low income Kentuckians. In total, transfers out increased \$13.5 million or 8.5% during the current year.

### Currently Known Facts, Decisions, Or Conditions

With the passage of legislation in Indiana to allow dockside gaming, the Kentucky Lottery Corporation will face even more competition in FY 03 from the Indiana Riverboat casinos that currently operate along Kentucky's Ohio River border. The legislation was enacted in August 2002 and is projected to increase casino gaming revenues by 30%.

With the addition of Pennsylvania in June 2002 and South Carolina in October 2002, the MUSL organization will make certain changes to the Powerball game which are scheduled to be implemented in October 2002. Among those changes will be an increase in the pool of numbers from which the players will select their numbers. With these changes larger jackpots, more frequent high jackpots, and faster growth in jackpots could all occur and increase sales.

### ***Management's Discussion and Analysis (Continued)***

#### **Contacting the KLC's Financial Management**

This financial report is designed to provide the public and other interested parties with an overview of the financial results of the KLC's activities, and to show the KLC's accountability for the revenue that it generates. If you have any questions about this report or need additional financial information, contact the Chief Financial Officer at the Kentucky Lottery Corporation, 1011 West Main Street, Louisville, Kentucky 40202.



KENTUCKY LOTTERY CORPORATION  
STATEMENTS OF NET ASSETS  
June 30, 2002 and 2001  
(dollars in thousands)

	<u>2002</u>	<u>2001</u>
<u>ASSETS</u>		
Current assets:		
Cash and equivalents	\$ 23,410	\$ 27,221
Investments at fair value, current portion	27,665	27,615
Accounts receivable, net	17,774	21,149
Ticket inventories	519	340
Deposits with Commonwealth of Kentucky	115	-
Other	462	688
Total current assets	<u>69,945</u>	<u>77,013</u>
Investments at fair value, less current portion	225,498	231,000
Capital assets, net	13,159	11,213
Deposits with Multi-State Lottery Association	3,606	3,630
Total assets	<u>312,208</u>	<u>322,856</u>
<u>LIABILITIES</u>		
Current liabilities:		
Accounts payable and accrued expenses	6,441	6,140
Due to other funds	3,692	5,145
Notes payable, current portion	339	1,356
Estimated prize liability, current portion	47,802	45,261
Total current liabilities	<u>58,274</u>	<u>57,902</u>
Notes payable, less current portion	-	341
Estimated prize liability, less current portion	205,019	217,979
Total liabilities	<u>263,293</u>	<u>276,222</u>
<u>NET ASSETS</u>		
Invested in capital assets, net of related debt	12,820	9,516
Restricted for unrealized gains on investments	22,469	14,864
Unrestricted	13,626	22,254
Total net assets	<u>\$ 48,915</u>	<u>\$ 46,634</u>

See accompanying notes.

KENTUCKY LOTTERY CORPORATION  
STATEMENTS OF REVENUES, EXPENSES AND CHANGES IN NET ASSETS  
for the years ended June 30, 2002 and 2001  
(dollars in thousands)

	<u>2002</u>	<u>2001</u>
Operating revenues:		
Instant games	\$ 329,891	\$ 305,602
On-line games	<u>308,837</u>	<u>285,249</u>
Total operating revenues	<u>638,728</u>	<u>590,851</u>
Direct costs:		
Commissions to retailers	<u>39,842</u>	<u>36,344</u>
Prize expense:		
Instant games	218,777	197,884
On-line games	<u>165,450</u>	<u>151,936</u>
Total prize expense	<u>384,227</u>	<u>349,820</u>
Ticket costs	<u>6,951</u>	<u>6,578</u>
Total direct costs	<u>431,020</u>	<u>392,742</u>
Gross profit	<u>207,708</u>	<u>198,109</u>
Operating expenses:		
Advertising and promotion	8,928	10,183
Salaries, wages and benefits	11,480	10,990
Contracted and professional services	12,537	11,454
Depreciation	2,627	3,207
Other general and administrative	<u>5,660</u>	<u>5,806</u>
Total operating expenses	<u>41,232</u>	<u>41,640</u>
Operating income	<u>166,476</u>	<u>156,469</u>
Nonoperating income (expense):		
Investment income	23,449	32,469
Loss on single cash payments – Note 13	-	(7,616)
Interest expense	(15,127)	(21,646)
Other income	<u>175</u>	<u>250</u>
Total nonoperating income (expense)	<u>8,497</u>	<u>3,457</u>
Income before transfers out	174,973	159,926

See accompanying notes.

KENTUCKY LOTTERY CORPORATION  
STATEMENTS OF REVENUES, EXPENSES AND CHANGES IN NET ASSETS (CONTINUED)  
for the years ended June 30, 2002 and 2001  
(dollars in thousands)

	<u>2002</u>	<u>2001</u>
Transfers out		
General Fund	(169,000)	(154,000)
Affordable Housing Trust	<u>(3,692)</u>	<u>(5,145)</u>
Total transfers out	(172,692)	(159,145)
Increase in net assets	2,281	781
Net assets, beginning of year	<u>46,634</u>	<u>45,853</u>
Net assets, end of year	<u><u>\$ 48,915</u></u>	<u><u>\$ 46,634</u></u>

See accompanying notes.

KENTUCKY LOTTERY CORPORATION  
STATEMENTS OF CASH FLOWS  
for the years ended June 30, 2002 and 2001  
(dollars in thousands)

	2002	2001
Cash flows from operating activities:		
Cash received from customers	\$ 642,209	\$ 589,356
Cash payments to suppliers for goods and services	(483,837)	(503,107)
Cash payments to employees for services	(11,480)	(10,990)
	<u>146,892</u>	<u>75,259</u>
Net cash provided by operating activities		
Cash flows from noncapital financing activities:		
Transfers out	(174,145)	(159,905)
	<u></u>	<u></u>
Cash flows from capital and related financing activities:		
Purchases of capital assets, net	(4,059)	(1,658)
Proceeds from disposal of equipment	9	98
Repayments of long-term debt	(1,358)	(1,356)
Interest expense	(73)	(165)
	<u>(5,481)</u>	<u>(3,081)</u>
Net cash used in capital and related financing activities		
Cash flows from investing activities:		
Proceeds from sale of investments	29,188	87,132
Purchase of investments	(1,077)	(4,431)
Deposits with Multi-State Lottery Association	24	161
Investment income	788	2,293
	<u>28,923</u>	<u>85,155</u>
Net cash provided by investing activities		
Net increase (decrease) in cash and equivalents	(3,811)	(2,572)
Cash and equivalents at beginning of year	27,221	29,793
	<u>27,221</u>	<u>29,793</u>
Cash and equivalents at end of year	<u>\$ 23,410</u>	<u>\$ 27,221</u>

See accompanying notes.

KENTUCKY LOTTERY CORPORATION  
STATEMENTS OF CASH FLOWS (CONTINUED)  
for the years ended June 30, 2002 and 2001  
(dollars in thousands)

	<u>2002</u>	<u>2001</u>
Reconciliation of operating income to net cash provided by operating activities:		
Operating income	\$ 166,476	\$ 156,469
Adjustments to reconcile operating income to net cash provided by operating activities:		
Depreciation	2,627	3,207
Bad debt expense	65	0
Increase (decrease) in cash due to changes in:		
Accounts receivable, net	3,310	(1,672)
Ticket inventories	(179)	45
Deposits with Commonwealth of Kentucky	(115)	487
Other assets	226	(339)
Accounts payable and accrued expenses	(219)	535
Dividends payable	(1,453)	(760)
Estimated prize liability	<u>(23,846)</u>	<u>(82,713)</u>
Total adjustments	<u>(19,584)</u>	<u>(81,210)</u>
Net cash provided by operating activities	<u>\$ 146,892</u>	<u>\$ 75,259</u>

Noncash capital and investing activities:

The accretion of interest on investments held to fund grand prizes, which increased prize liability, totaled \$15,054 and \$21,481 for the years ended June 30, 2002 and 2001, respectively.

The fair value of investments increased \$7,605 in 2002 and \$1,099 in 2001.

The purchase of property and equipment included in accounts payable totaled \$520 at June 30, 2002.

See accompanying notes.

KENTUCKY LOTTERY CORPORATION  
NOTES TO FINANCIAL STATEMENTS  
JUNE 30, 2002 AND 2001

NOTE 1 - ORGANIZATION

The Kentucky Lottery Corporation (the Corporation) was created with the enactment of House Bill No. 1 in December 1988 as an independent de jure municipal corporation and political subdivision of the Commonwealth of Kentucky (the Commonwealth). The Corporation is to be managed in such a manner that enables the people of the Commonwealth to benefit from its profits and to enjoy the best possible lottery games. The operations of the Corporation are separate and distinct from other operations of the Commonwealth.

The Corporation commenced operations on April 4, 1989 with the sale of instant game tickets. Sales of on-line games began October 16, 1989. In January 1991, the Corporation joined the Multi-State Lottery Association, a group of states that combine lottery sales for on-line games.

NOTE 2 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Reporting Entity:

The Corporation has adopted the provisions of Government Accounting Standards Board (GASB) Statement No. 14, *The Financial Reporting Entity*, under which the financial statements include all the organizations, activities, functions and component units for which the Corporation is financially accountable. Financial accountability is defined as the appointment of a voting majority of the component unit's board, and either (1) the Corporation's ability to impose its will over the component unit, or (2) the possibility that the component unit will provide a financial benefit to or impose a financial burden on the Corporation.

The Corporation has determined that no outside agency meets the above criteria and, therefore, no other agency has been included as a component unit in the Corporation's financial statements. In addition, since the Corporation provides a financial benefit for the Commonwealth, the Corporation is part of the reporting entity of the Commonwealth and is, therefore, included in the Commonwealth's Annual Financial Report. The accompanying financial statements are not intended to present the financial position or the results of operations and cash flows of the Commonwealth of Kentucky or its proprietary funds.

Basis of Presentation:

The Corporation is accounted for as an enterprise fund. The financial statements are prepared on the accrual basis of accounting in accordance with accounting principles generally accepted in the United States of America. The Corporation has elected to apply all applicable GASB pronouncements as well as Financial Accounting Standards Board (FASB) pronouncements and Accounting Principles Board (APB) opinions issued on or before November 30, 1989, unless those pronouncements conflict with or contradict GASB pronouncements. The Corporation has further elected not to apply FASB pronouncements issued after November 30, 1989, in accordance with GASB Statement No. 20.

In June 1999, GASB unanimously approved Statement No. 34, *Basic Financial Statements-and Management's Discussion and Analysis-for State and Local Governments*. This statement is required to be implemented for the Corporation for the year ended June 30, 2002. For the first time the financial statements include a Management's Discussion and Analysis (MD&A) section providing an analysis of the Corporation's overall financial position and results of operations. This and other changes are reflected in the accompanying financial statements (including notes to the financial statements).

KENTUCKY LOTTERY CORPORATION  
NOTES TO FINANCIAL STATEMENTS  
JUNE 30, 2002 AND 2001

NOTE 2 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

Revenue and Accounts Receivable Recognition:

Revenue and accounts receivable for on-line games are recognized when tickets are sold to the public by contracted retailers.

Revenue and accounts receivable for instant scratch games are recognized upon activation of tickets for sale by the retailers, or 50 days from the date of issuance of the tickets to the retailers, whichever is sooner.

Allowance for Doubtful Accounts:

The Corporation uses the allowance method to account for uncollectible accounts receivable.

Prizes:

Prize expense for instant ticket games is recorded as an estimate at the time the related revenue is recognized based on the predetermined prize structure for each game; periodically, the prize expense is adjusted to reflect amounts actually won. Prize expense for on-line games is recorded at the time the related revenue is recognized based on the known prize payout structure.

Grand prizes are awarded related to the Lotto Kentucky, Lotto South and Powerball on-line games. Lotto Kentucky grand prizes are paid in twenty equal annual installments or in a single lump-sum payment equal to the estimated present cash value of twenty annual payments. For Lotto Kentucky winners electing annual installments, the actual prize expense is the cost of the U.S. Treasury zero coupon bonds which the Corporation purchases to fund the annual payments. For Lotto Kentucky winners electing present cash value, the actual prize expense is the lump-sum payment equal to the cost of U.S. Treasury zero coupon bonds, priced seven days prior to the draw date, as if the Corporation was to fund twenty equal annual installments. During the year ended June 30, 2002, the Lotto Kentucky game was discontinued and replaced with the Lotto South game.

Lotto South grand prizes are paid in thirty equal annual installments or in a single lump-sum payment equal to the estimated present cash value of thirty annual payments. The Corporation recognizes Lotto South prize expense at the time the related revenue is recognized based on the known prize payout structure. A portion of Lotto South sales of the Corporation is remitted to the Virginia State Lottery, the designated administrator for Lotto South, to fund prize payments. All Lotto South grand prizes for winners electing annual installments are funded through the purchase of U.S. Government agency securities. The Party Lottery which sold the grand prize winning ticket has the first option of purchasing the investments, but may defer the purchase to another Party Lottery.

Powerball grand prizes are paid in twenty-five equal annual installments or in a single lump-sum payment equal to the estimated present cash value of twenty-five annual payments, except for payments made to winners under the single cash payment prize option described in Note 13. The Corporation recognizes Powerball prize expense at the time the related revenue is recognized based on the known prize payout structure. A portion of Powerball sales of the Corporation is remitted to the Multi-State Lottery Association (MUSL) to fund prize payments. MUSL purchases U.S. Government agency securities to fund prize liability to Powerball winners electing annual installments.

KENTUCKY LOTTERY CORPORATION  
NOTES TO FINANCIAL STATEMENTS  
JUNE 30, 2002 AND 2001

NOTE 2 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

Cash and Equivalents:

For financial statement purposes, the Corporation considers all highly liquid investments with an original maturity of three months or less to be cash equivalents.

Investments:

Investments consist of U.S. Treasury zero coupon bonds and other U.S. Government agency securities carried at fair value in accordance with GASB Statement No. 31, *Accounting and Financial Reporting for Certain Investments and for External Investment Pools*. Fair value of investments is based on quoted market prices. Investments are in U.S. Treasury zero coupon bonds and are purchased to meet future installment payments to prize winners. There are generally no available realized gains or losses on investments, as it is the Corporation's policy to hold the investments to maturity. The difference between fair value and the amortized cost is reflected as a restriction of net assets for unrealized gains on investments.

Ticket Inventories:

Inventories are carried at cost (as determined by the specific identification method) and consist of pull-tab tickets located in the Corporation's warehouses or held by retailers. The cost of tickets is charged to operations upon the recognition of revenue under the procedures described above.

Property and Equipment:

Property and equipment are carried at cost less accumulated depreciation. Depreciation is computed using the straight-line method over estimated lives of three to thirty years. When assets are retired or otherwise disposed of, the cost and related accumulated depreciation are removed from the accounts and any resulting gain or loss is reflected in operations in the period of disposal. Amortization of leasehold improvements is computed using the straight-line method over lease terms of three to five years.

Deposits with Multi-State Lottery Association (MUSL):

Deposits are carried at cost. MUSL is an unincorporated government-benefit voluntary association created for the purpose of administering joint lottery games, such as Powerball and Instant Powerball TV Game Show. MUSL currently includes 22 state lottery entities and the District of Columbia. The chief executive officer of each member lottery serves on the MUSL board of directors. As a member of MUSL, the Corporation is required to contribute to various prize reserve funds maintained by MUSL. The prize reserve funds serve as a contingency reserve to protect MUSL from unforeseen prize liabilities. All prize reserve funds remitted, and the related interest earnings, will be returned to the Corporation upon leaving MUSL, less any portion of unanticipated prize claims which may have been paid from the fund.

Estimated Prize Liability:

A liability for grand prize winners electing equal annual installments is recorded based on the cost of U.S. Treasury zero coupon bonds and other U.S. Government agency securities purchased to fund the liability, adjusted for the accretion of interest based upon the purchased yield and maturity date. The estimated prize liability is presented in the statement of net assets net of this imputed interest. Imputed interest is amortized to interest expense over the life of the annuity utilizing the effective interest method.



KENTUCKY LOTTERY CORPORATION  
NOTES TO FINANCIAL STATEMENTS  
JUNE 30, 2002 AND 2001

NOTE 2 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

Due to other funds:

A liability for amounts due to other funds results from amounts payable to either the Commonwealth's general fund or to the Affordable Housing Trust Fund. The amount payable to the Affordable Housing Trust Fund results from unclaimed prizes on instant and on-line games. Prizes not claimed within 180 days of drawing date for on-line games or game ending date for instant tickets are forfeited and considered unclaimed. In accordance with Kentucky Revised Statute (KRS) 154A.110(3), any unclaimed prize money from these games may be retained by the Corporation and added to the pool from which future prizes are to be awarded or used for special prize promotions, or may be appropriated by the General Assembly directly from the Corporation for any public purpose. Any unclaimed prize money in excess of \$6,000,000 per fiscal year is transferred to the Affordable Housing Trust Fund, as required by KRS 154A.110(3). Payments are made as necessary during January and/or July of each fiscal year, depending on the volume of unclaimed prizes.

Transfers out:

Transfers out represents a transfer of funds from the Corporation to the Commonwealth's general fund and the Affordable Housing Trust Fund. The transfers out to the general fund, which are approved by the Board of Directors and remitted to the Commonwealth on a monthly basis, are used to benefit all Kentuckians. The transfers out to the Affordable Housing Trust Fund are used to address the critical housing needs of extremely low income Kentuckians.

Use of Estimates:

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities as of the dates of the financial statements and the reported amounts of revenues and expenses during the reporting periods. Actual results could differ from those estimates.

NOTE 3 - CASH AND EQUIVALENTS

Cash and equivalents includes bank balances of approximately \$130,000 at June 30, 2002 which are fully covered by federal depository insurance. Also included in cash and equivalents at June 30, 2002 are overnight repurchase agreements of \$22,024,000 which are classified as Category 1 investments. The Corporation's investments are categorized to give an indication of the level of credit risk assumed by the Corporation at year-end. Category 1 is comprised of investments that are either insured or registered, or for which the securities are held by the Corporation's agent in the Corporation's name.

NOTE 4 - INVESTMENTS

The Corporation has adopted GASB Statement No. 31, *Accounting and Financial Reporting for Certain Investments and for External Investment Pools*, which establishes accounting and reporting guidelines for government investments and investment pools. The adoption of this statement requires investments to be presented at fair value. When compared to the historical cost method, this results in additional income of approximately \$7,605,000 in 2002 and \$1,099,000 in 2001.

KENTUCKY LOTTERY CORPORATION  
NOTES TO FINANCIAL STATEMENTS  
JUNE 30, 2002 AND 2001

NOTE 4 - INVESTMENTS (CONTINUED)

The net increase in the fair value of investments includes all changes in fair value that occurred during the year. The components of investment income for the years ended June 30, 2002 and 2001 consisted of the following (in thousands):

	<u>2002</u>	<u>2001</u>
Net increase in fair value of investments	\$ 22,661	\$ 30,175
Interest income	731	2,216
Security lending income	<u>57</u>	<u>78</u>
Total investment income	<u>\$ 23,449</u>	<u>\$ 32,469</u>

All investments held at June 30, 2002 and 2001 were in Category 1 and were held in U.S. Treasury zero coupon bonds and other U.S. Government agency securities.

Grand prize investments at June 30, 2002 and 2001 consisted of the following (in thousands):

	<u>2002</u>	<u>2001</u>
Direct U.S. Treasury Investments	\$ 118,098	\$ 122,212
Other U.S. Governmental Agency Securities	<u>135,065</u>	<u>136,403</u>
	<u>\$ 253,163</u>	<u>\$ 258,615</u>

The Corporation is authorized by state statutes and investment policies approved by the Board of Directors to lend its investment securities. The lending is managed by the Corporation's custodial bank. All loans can be terminated on demand by either the Corporation or the borrowers, although the average term of loans is approximately one week. The custodial bank and its affiliates are prohibited from borrowing the Corporation's securities.

The custodial bank lends the Corporation's U.S. Treasury zero coupon bonds and other U.S. Government agency securities for securities collateral of 102 percent. The securities lending contracts do not allow the Corporation to pledge or sell any collateral securities unless the borrower defaults. There are no restrictions on the amount of securities that can be lent at one time or to one borrower.

At June 30, 2002 and 2001, the Corporation had loaned investments with fair values of approximately \$18,542,000 and \$42,956,000, respectively, to authorized brokers for a fee. In exchange for the loaned investments, the Corporation has temporarily received direct obligations of the U.S. Treasury and securities issued by U.S. Government agencies with fair values of approximately \$19,299,000 and \$57,523,000 at June 30, 2002 and 2001, respectively, which are held by the Corporation's custodial bank in the Corporation's name. The Corporation's loaned investments are included in the investments reported in the financial statements rather than the securities received in the exchange.

KENTUCKY LOTTERY CORPORATION  
NOTES TO FINANCIAL STATEMENTS  
JUNE 30, 2002 AND 2001

NOTE 4 - INVESTMENTS (CONTINUED)

The lending agent provides indemnification if the borrowers fail to return the underlying securities (and if the collateral is inadequate to replace the securities lent) or fail to pay income distributions on them. There were no violations of legal or contractual provisions, no borrower or lending agent default losses, and no recoveries of prior-period losses during the year. There are no income distributions owing on the securities lent. All borrower rebates, agent fees, and lender's net earnings were fully paid at year-end.

NOTE 5 - ACCOUNTS RECEIVABLE

Accounts receivable at June 30 consisted of the following (in thousands):

	<u>2002</u>	<u>2001</u>
Accounts receivable	\$ 18,086	\$ 21,473
Allowance for doubtful accounts	<u>(312)</u>	<u>(324)</u>
Accounts receivable, net	<u>\$ 17,774</u>	<u>\$ 21,149</u>

NOTE 6 - CAPITAL ASSETS

Capital asset activity for the year ended June 30, 2002 was as follows (in thousands):

	<u>Beginning Balance</u>	<u>Increases</u>	<u>Decreases</u>	<u>Ending Balance</u>
Capital assets not being depreciated:				
Land	\$ 423	\$ -	\$ -	\$ 423
Software development in progress	-	2,509	-	2,509
Total capital assets not being depreciated	<u>423</u>	<u>2,509</u>	<u>0</u>	<u>2,932</u>
Other capital assets:				
Buildings	7,142	1		7,143
Leasehold improvements	327			327
Game equipment	9,899	94		9,993
Data processing equipment	14,588	1,730	(157)	16,161
Automobiles, furniture and fixtures	3,453	247	(3)	3,697
Total other capital assets at historical cost	<u>35,409</u>	<u>2,072</u>	<u>(160)</u>	<u>37,321</u>
Less accumulated depreciation	<u>(24,619)</u>	<u>(2,627)</u>	<u>152</u>	<u>(27,094)</u>
Net capital assets	<u>\$ 11,213</u>	<u>\$ 1,954</u>	<u>\$ (8)</u>	<u>\$ 13,159</u>

KENTUCKY LOTTERY CORPORATION  
NOTES TO FINANCIAL STATEMENTS  
JUNE 30, 2002 AND 2001

NOTE 6 - CAPITAL ASSETS (CONTINUED)

Capital asset activity for the year ended June 30, 2001 was as follows (in thousands):

	Beginning Balance	Increases	Decreases	Ending Balance
Capital assets not being depreciated:				
Land	\$ 423	\$ -	\$ -	\$ 423
Other capital assets:				
Buildings	7,129	13		7,142
Leasehold improvements	327	1	(1)	327
Game equipment	9,389	557	(47)	9,899
Data processing equipment	13,935	866	(213)	14,588
Automobiles, furniture and fixtures	3,232	238	(17)	3,453
Total other capital assets at historical cost	34,012	1,675	(278)	35,409
Less accumulated depreciation	(21,666)	(3,207)	254	(24,619)
Net capital assets	<u>\$ 12,769</u>	<u>\$ (1,532)</u>	<u>\$ (24)</u>	<u>\$ 11,213</u>

NOTE 7 - NOTES PAYABLE

The Corporation has a note payable requiring monthly interest payments with an annual interest rate of 6.66%. The note is collateralized by real estate and matures September 2002. Note payable activity for the years ended June 30, 2002 and 2001 was as follows (in thousands):

Year ending June 30,	Beginning Balance	Additions	Reductions	Ending Balance	Amounts Due Within One Year
2002	\$ 1,697	\$ -	\$ (1,358)	\$ 339	\$ 339
2001	\$ 3,055	\$ -	\$ (1,358)	\$ 1,697	\$ 1,356

Debt service requirements at June 30, 2002 were as follows (in thousands):

	Principal	Interest
2003	<u>\$ 339</u>	<u>\$ 4</u>

KENTUCKY LOTTERY CORPORATION  
NOTES TO FINANCIAL STATEMENTS  
JUNE 30, 2002 AND 2001

NOTE 8 - ESTIMATED PRIZE LIABILITY

Estimated prize liability at June 30 consisted of the following (in thousands):

	<u>2002</u>	<u>2001</u>
Current:		
Grand prizes	\$ 29,288	\$ 27,615
Other prizes	<u>18,514</u>	<u>17,646</u>
Total current portion	<u><u>\$ 47,802</u></u>	<u><u>\$ 45,261</u></u>
Long-term:		
Grand prizes	<u><u>\$ 205,019</u></u>	<u><u>\$ 217,979</u></u>

Long-term liability activity of grand prize awards payable was as follows (in thousands):

<u>Year ending June 30,</u>	<u>Beginning Balance</u>	<u>Increases</u>	<u>Decreases</u>	<u>Ending Balance</u>
2002	\$ 245,594	\$ 17,957	\$ (29,244)	\$ 234,307
2001	\$ 299,215	\$ 25,795	\$ (79,416)	\$ 245,594

Liabilities for future payments of grand prize liabilities are summarized as follows (in thousands):

<u>Year ending June 30,</u>	
2003	\$ 29,288
2004	29,287
2005	29,288
2006	29,287
2007	29,288
2008 through 2012	134,875
2013 through 2017	51,709
2018 through 2022	2,430
2013 through 2027	<u>1,120</u>
Total	336,572
Less unamortized discount	<u>(102,265)</u>
Total at present value	234,307
Less current portion	<u>(29,288)</u>
Total long-term portion at present value	<u><u>\$ 205,019</u></u>

KENTUCKY LOTTERY CORPORATION  
NOTES TO FINANCIAL STATEMENTS  
JUNE 30, 2002 AND 2001

NOTE 8 - ESTIMATED PRIZE LIABILITY (CONTINUED)

Estimated prize liability for grand prizes is based on the cost of U.S. Treasury zero coupon bonds and other U.S. Government agency securities purchased to fund the liability, adjusted for the accretion of interest based upon the purchased yield and maturity date. This adjustment of approximately \$15,054,000 and \$21,481,000 in 2002 and 2001, respectively, is included in interest expense. Interest expense for the years ended June 30, 2002 and 2001 consisted of (in thousands):

	<u>2002</u>	<u>2001</u>
Amortization of discount on estimated prize liability	\$ 15,054	\$ 21,481
Interest on notes payable	<u>73</u>	<u>165</u>
Total interest expense	<u>\$ 15,127</u>	<u>\$ 21,646</u>

NOTE 9 - RETIREMENT PLAN

The Corporation has a defined contribution retirement plan (the Plan) which covers all full-time employees. Under the terms of the Plan, the Corporation and employees each contribute 6.2% of the employee's earned annual base salary, as defined. Employees become eligible for participation and are fully vested at the date of employment for this portion of the Plan.

The Corporation also makes a contribution equal to 8% of the employee's earned annual base salary. For this portion, employees hired prior to October 1, 1993 became eligible at the date of employment and are fully vested providing participation requirements are met. Employees hired after September 30, 1993 become eligible one year after the date of employment and are fully vested after five years of service providing participation requirements are met.

For 2002 and 2001, total payroll was approximately \$8,828,000 and \$8,649,000, respectively. During 2002 and 2001, the Corporation's contributions were calculated using the base salary amount for full-time employees of \$8,361,000 and \$8,117,000, respectively, for the 6.2% employer match contribution, and \$8,099,000 and \$8,447,000, respectively, for the 8% additional employer contribution. Employer requirements and contributions actually made to the Plan were approximately \$1,166,000 and \$1,130,000 (13.9% and 13.6% of covered payroll) and employee contributions to the Plan were approximately \$518,000 and \$506,000 (6.20% of covered payroll) in 2002 and 2001, respectively.

In addition to the above defined contribution retirement plan, the Corporation's employees are also eligible to participate in two deferred compensation plans sponsored by the Commonwealth of Kentucky. These plans are organized as a Section 457 plan and as a Section 401(k) plan under the Internal Revenue Code. Both plans permit employees to defer a portion of their salary until future years. Deferred compensation is not available to employees until termination, retirement, death, or financial hardship. The Commonwealth of Kentucky's Comprehensive Annual Financial reports should be referred to for further disclosures related to the deferred compensation plans.

KENTUCKY LOTTERY CORPORATION  
NOTES TO FINANCIAL STATEMENTS  
JUNE 30, 2002 AND 2001

NOTE 10 - LEASES

The Corporation has entered into operating leases for the rental of office and warehouse space under initial lease terms of one to five years.

Approximate minimum rental payments are (in thousands):

<u>Year ending June 30,</u>	
2003	\$ 157
2004	115
2005	42
2006	28
2007	<u>14</u>
Total	<u>\$ 356</u>

Rental expense for 2002 and 2001 was approximately \$265,000 and \$279,000, respectively.

NOTE 11 - TRANSFERS OUT

Transfers out to the general fund for the years ended June 30, 2002 and 2001 included approximately \$99,000,000 and \$74,000,000, respectively, that were required by KRS 154A.130(4)(b) to be credited from the general fund to the Collaborative Center for Literacy Development, the Early Reading Incentive Fund, the Wallace G. Wilkinson Educational Excellence Scholarship Fund, the College Access Program and the Kentucky Tuition Grants Program.

NOTE 12 - INSURANCE

The Corporation is exposed to various risks of loss related to torts; theft of, damage to, and the destruction of assets; errors and omissions; injuries to employees; and natural disasters. The Corporation has purchased commercial insurance to cover these risks except for the asset value of certain gaming equipment located at retail establishments in which the Corporation retains risk of loss. As of June 30, 2002, there were no outstanding liabilities or unpaid claims regarding this gaming equipment. The amount of commercial coverage has not decreased nor has the amount of settlements exceeded coverage in any of the past three fiscal years. It is also the policy of the Corporation to purchase a portion of the medical insurance needed to cover its employees.

KENTUCKY LOTTERY CORPORATION  
NOTES TO FINANCIAL STATEMENTS  
JUNE 30, 2002 AND 2001

NOTE 13 - INTERNAL REVENUE CODE SECTION 451(H)

As part of the Omnibus Consolidated and Emergency Supplemental Appropriations Bill for Fiscal Year 1999, Congress changed the rules under which certain lottery prizes are taxed. The changes to Section 451(h) of the Internal Revenue Code became effective on October 21, 1998. A transition rule provision exists that allows pre-October 22, 1998 winners, if there is an option, to elect a single cash payment of the remaining value of their prize within an 18-month period beginning July 1, 1999.

On May 3, 2000, the Corporation notified claimants of qualified prizes as defined in the Corporation's Rules and Regulations of the "special claim period" to exercise an option to receive the lump-sum cash value equivalency of their remaining annuitized prizes. The claim period is available through December 29, 2000 to the eligible winners. There were 189 prize winners eligible for this option as of the date of notification. During the year ending June 30, 2001, 44 winners exercised their option and were paid the single cash payment option. The fair market value of investments sold to meet these obligations was \$56,505,238 and grand prizes payable were reduced by \$48,888,856. The Corporation recorded a loss of approximately \$7,616,000 on these single cash payments in fiscal year 2001.

NOTE 14 - COMMITMENTS AND CONTINGENCIES

From time to time, the Corporation is party to lawsuits and claims arising in the normal course of business. The Corporation has defended and intends to continue to defend these actions vigorously and believes, based on currently available information, that adverse settlements, if any, will not be material to the financial statements.





KENTUCKY LOTTERY CORPORATION  
SCHEDULE OF FINDINGS  
Year Ended June 30, 2002

Schedule of auditor's results

We have issued an unqualified opinion, dated July 26, 2002, on the financial statements of the Kentucky Lottery Corporation as of and for the year ended June 30, 2002.

Our audit disclosed no instances of noncompliance which are material to the Kentucky Lottery Corporation's financial statements.

Findings relating to the financial statements

Our audit disclosed no findings which are required to be reported in accordance with *Government Auditing Standards*.

KENTUCKY LOTTERY CORPORATION  
SCHEDULE OF PRIOR AUDIT FINDINGS AND THEIR RESOLUTIONS  
Year Ended June 30, 2001

The prior year's audit disclosed no findings which are required to be reported in accordance with *Government Auditing Standards*.